China's Foreign Exchange Regime and Financial Policies

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JEL CODES: E 44, F 41; F 53; O 53

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I Introduction

The choice and reform of exchange rate regime has wide implications both for domestic and external balances of an economy. The theoretical and policy arguments in favor and against reform measures remain contentious. The experiences in the 1990s in currency crisis across several developing and emerging economies underlined the risks and cost of unsustainable exchange rate policies and the lack of institutional capacity to monitor and implement such policies.

The nature, stage of development, institutional capacity, level of integration in the global economy of emerging and developing countries has further compounded the capacity of such economies to design and undertake reforms in their exchange rate regime. Exchange rate regime changes in such economies were often times undertaken in response to currency or economic crisis. If and when a country is faced with the need to change its exchange rate regime, the move involves moving away from the current position to that of an independently floating, managed floating, hard peg or a currency board arrangement. However, it is possible to consider the three options in a continuum of possibilities and discretions that could be exercised by local monetary authorities: floating, intermediate, and fixed.

The issue of policy interest is that what kind of exchange rate regime is suitable for a developing country? Could the structure, level and growth rate of the domestic economy and external trade influence the type of exchange rate regime a country could adopt and pursue on a sustainable manner? Does such a policy regime shift have implications for trading and investment partners abroad? These are some of the issues that will be addressed in this paper with particular focus on China.

China has registered remarkable economic growth rate in recent years. This growth performance has been sustained by considerable increase in the domestic investment rate that stands about 42.7 percent of GDP in 2005. This high investment rate is supported by similarly high national saving rate that was 52 percent of GDP in 2005. These features were also accompanied by increases in international trade, inflow of foreign direct investment and integration of the Chinese economy in the global market system.

China maintained a fixed exchange rate regime from 1994 to July 2005 that maintained the exchange rate of Chinese Yuan at a rate of 8.28 per US dollar. The 1997-98 financial crisis in Asia forced most economies in the region to abandon their dollar peg and float their currencies, often times in response to the crisis. China resisted the pressure to float its currency and in effect abandon its exchange rate policy and in the process helped stabilize the volatile international financial crisis of the 1990s. The exchange rate policy stance of China during the 1990s and its resistance to shift course was used as a source of criticism to its policies from its trading partners and competitors. The increase in export relative to imports resulted in the rise of considerable amount of current account surplus that was channeled to increase the international reserve position of the country. The increase in China's trade surplus which was mirrored by the increasing trade deficit among its main trade partners, especially USA, drew criticism that often times was explained as caused by the under valuation of the renminbi [RMB]. This fed itself into protectionist sentiments and political pressure to change the exchange rate.

It was in this context that China finally abandoned its exchange rate policy of dollar peg starting from July 21, 2005 and replaced it with a managed floating exchange rate regime (PBOC, 2005). The RMB exchange rate was revalued from 8.28 to the US dollar to 8.11 that amounted to a 2.1 percent revaluation of the RMB. The new policy stated that the RMB exchange rate would not be pegged to the US dollar and instead a basket of currencies be used as reference to set the exchange rate depending on trade, investment and foreign debt relationship of major trading partner countries.

The shift in policy regime accomplished a number of objectives. It abandoned the dollar peg in favor an exchange rate regime that takes into consideration the relative importance of trade and investment partners. It also allows more flexible setting of the exchange rate with a narrow band of 0.3 percent of a central parity within which the exchange rate to move. The fact that the PBOC is not committed to define and protect the central parity allowed discretion for monetary authorities to set their target depending on market developments and economic and financial situation. By implication this policy stance allowed the Chinese monetary authorities to address the issues of competitive exchange rate management of its competitors within Asia unlike the passive stance of fixed dollar peg regime.

The adoption of the new exchange rate regime in China and the gradual appreciation of the currency against the dollar pose yet other issues of policy interest. Is China abandoning its dollar peg in favor of moving to the independently floating exchange rate regime in which market forces shape the direction of the exchange rate and the policy target of PBOC will eventually change? If so how long should the transition take? Can an economy that features distinctive elements of a fast growing developing country with the export sector playing an important role in the growth process move away to floating exchange rate regime without disrupting the growth momentum? If the exchange policy regime reforms were meant to replace the fixed peg to that of managed floating, would such a policy be sustainable in the short and long term? Does appropriate exchange regime reform for China mean a move to a regime of flexible exchange rate regime from the fixed exchange rate?(Summers 2000) Or does a managed floating exchange rate policy would be more appropriate? (Frankel, 2005; Williamson, 2000).

The theme of this paper is that China should maintain a stable exchange rate regime, short of a fixed dollar-peg, or move towards an independently floating regime. The middle ground, while appealing for short-term management of the exchange rate and as a transition towards such an objective, could not be sustainable and involves cost to the economy. The rest of the paper is organized as follows. The next section addresses the exchange rate regime reform of China in the context of emerging economies and the underlying factors in favor or against such a policy stance. Section three deals with the behavior and characteristics of the exchange rate of the RMB after the policy shift. Second four discusses the policy options and rationale for a more independent monetary policy that could maintain the growth momentum and help in addressing pressing economic and social problems of China. The last section draws concluding remarks.

II The Exchange Rate Regime Shift

The issue of the appropriate level of exchange rate of the RMB against its nominal anchor, the US dollar, has not been clearly settled. The rapid economic growth rate, the increasing trade surplus of China against the US, and the low level of relative price in China suggest that the RMB is undervalued by about 34 percent (Frankel, 2005; Williamson, 2000). Despite the seemingly strong misalignment of the exchange rate from its long-term equilibrium, Cheung et al (2007) could not find statistically significant overvaluation of the RMB against the US dollar. It is under such an unsettled view and in response to the pressure from trading partners that the Chinese monetary authorities undertook the reform in their exchange rate regime.

On July 21 2005, the PBOC announced the reform of the RMB exchange rate regime (PBOC 2005). The announcement with authorization from the State Council of China addressed a number of important issues. First, it abandoned the fixed dollar peg of the RMB in favor of a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. It was a shift with space for flexible exchange rate. Second, it established a regime by which the PBOC announces the central parity rat, based on inter-bank foreign exchange market outcome, which serves as reference for trading the following trading day. Third, the PBOC adjusted the exchange rate of the RMB to 8.11 RMB per US dollar from 8.26RMB per US$ effectively revaluing the RMB by 2.1 percent. Fourth, the exchange rate of the RMB per US dollar in the inter-bank foreign exchange market would be allowed to float within a band of 0.03 percent around the central parity rate. The non-US dollar exchange rate against the RMB would be allowed to float based on the band to be announced by the PBOC. The provisions also allowed the PBOC to exercise discretionary measures depending on economic and financial conditions to manage the exchange rate movement.

The announcement is remarkable in a sense that despite resistance to maintain the fixed dollar peg, China finally abandoned its policy stance for a more managed floating exchange rate mechanism that takes into consideration changes in the market forces of demand and supply and conditions in the financial and economic sectors besides international financial situations. Unlike other cases of foreign exchange regime changes, China undertook its policy shift from a stance of economic strength. As was clearly observed during the Asian currency crisis where countries were forced to abandon their fixed dollar peg and allow their currency to depreciate considerably and trigger financial melt dawn, the case of China is more akin to the experience of Japan during the 1980s where pressure was put, often by external trading partners and debtors, to revalue the domestic currency against the US dollar in an attempt to reduce their external trade deficit [Frankel, 2005; McKinnon 2006]. The rationale behind such a pressure is the belief that the huge and increasing deficit in the USA is the result of exchange rate under valuation of the RMB. This view is contestable as trade deficit does not seem to respond on a sustainable manner to appreciation of the RMB as was also the case with the drastic appreciation of the Japanese Yen during the 1980s and 1990s. However, the similarities between Japan and China are limited as the two economies have major differences in several aspects of their economy. And yet, if China is to avoid the mistakes of Japan that allowed the yen to appreciate excessively and subjected itself to costly deflationary situation that resulted in economic stagnation for a long period, it is paramount to undertake exchange rate policy reforms after close deliberation of the consequences on the domestic economy.

III RMB Exchange Rate after policy shift

The shift in the exchange rate policy regime and its subsequent rate movement was not as dramatic as alluded to in the initial stage of the reform. The PBOC continues to tightly manage the exchange rate and keep the fluctuation of the exchange rate to a minimum. It takes continuous policy deliberation and monitoring the overall performance of the national economy with respect to the rest of the world to efficiently manage the exchange rate regime after the initial step of revaluation by 2.1 percent against the US dollar. The policy makers need to identify the appropriate equilibrium level of exchange rate of the RMB against the dollar once the decision was made to abandon the dollar peg that served as a nominal anchor for more than a decade. Even if the market and the policy makers seem to agree on the overall trend of RMB appreciation, the target level of exchange rate towards which the authorities manage the exchange rate to move is not a commonly shared view.

The PBOC initial announcement stated a narrow band of fluctuation around a central parity rate. The daily limit of fluctuation around the central parity was ±0.3 percent from July 21, 2005 until May 18, 2007 when the PBOC widened the range to ±0.5 percent of the central parity. Nonetheless, the daily fluctuation of the RMB exchange rate against the US dollar has rarely reached the limits of the band. The average movement for its first year of operation was 0.04 percent. The fixed dollar peg was abandoned but the rate was so managed within a narrow band that some ascribed the situation as more of a pegged regime than a managed floating (Ogawa 2006, Taniuchi 2007). The RMB is still closely tied to the US dollar.

There were, nonetheless, several but small measures that set the overall tone of the exchange rate regime of the RMB that might have important cumulative effect on the exchange rate movement. In November 2005 the PBOC effectively created a swap market in forward exchange by liberalizing capital controls on a selected domestic banks. The PBOC sold US$ 6 billion to 10 domestic banks and promised to buy back the dollar one year later at RMB7.85 per US$ against the spot rate of RMB8.08 per US$. This amounted to 2.9 percent forward discount that might announce to market participants the direction, if not the exact rate, of appreciation that the central bank would accommodate. The volume of transaction in foreign exchange swaps has increased considerably to a level of about US$ 1 billion per day in April 2007 and foreign exchange transactions are increasingly conducted by private sector. China also has allowed qualified domestic institutional investors to invest as much as half of their funds in overseas equities. These measures combined with external pressure would suggest that the RMB is on an appreciation path and building an appreciation expectation among market participants and setting a stage for one-way betting.

Intervention in the foreign exchange market is still strong and it resulted in an ever expansion of the foreign exchange reserves of China. The reserve level reached $1.066 trillion by the end of 2006 and by the end of the first quarter of 2007 the amount stood at $1.2 trillion [US treasury, 2007]. The main source of net foreign demand for the

RMB is trade surplus followed by net foreign direct investment.

China faces considerable domestic and external imbalances. The 11th Five Year Plan that was launched in 2006 recognized this problem and set a policy priority aimed at curbing such imbalances. The policy called for a shift in the composition of aggregate demand to rely less on investment and exports and more on domestic consumption. Nonetheless, investment and net exports remain dominant factors in GDP and its growth. More effective monetary policy could help rebalance the economy towards greater household consumption. The structure of the growth rate of China is increasingly a concern for policy makers. Premier Wen Jiabao reported to National People's Congress in March 2007 that "the biggest problem in China's economy is that the growth is unstable, imbalanced, uncoordinated and unsustainable."

How effectively does the fixed exchange rate regime and the nominal anchor to the US dollar help China achieve macroeconomic and external balances?

IV The Way forward for RMB

The future of the RMB exchange rate against the dollar and other basket currencies depends on a large measure on the performance of the global economy, the growth rate of China relative to the rest of the world, the policy stance of the PBOC with respect to the exchange regime and the role and expectation of market participants in an increasingly global and liberalized financial market.

Whatever the rationale or final justification for regime change, as the last two sections indicated, the PBOC abandoned its nominal anchor for exchange rate and pursued a managed floating regime in which a basket of undisclosed currencies are taken into consideration in guiding the exchange rate regime. So far, despite the general expectation of market participants for an appreciation of the RMB against the dollar, and perhaps other currencies, the rate of appreciation has been quite moderate. Despite the initial policy stance of moving away from the dollar peg, the exchange rate is tightly managed to remain with a narrow band of a gradually appreciating trend. The pace of appreciation and reluctance to move towards the independently floating regime suggests that the RMB-dollar exchange rate is bound to remain within a narrow band. The recent measures to relax the band in which the spot rate against the PBOC central parity rate fluctuates to 0.5 percent and the introduction and expansion of the forward currency swap might increase the pace of appreciation of the currency against the dollar.

The rate of appreciation, however, needs to be managed carefully so that it does not go beyond the productivity and income growth in the local economy relative to the major trading partners. It is also important to note that with the appreciation of the RMB, and especially if the pace of appreciation is faster than the growth of productivity in the tradable sector, it could lead the export sector loss its competitiveness relative to its rivals in the international market.

A closer examination of Figure 2 shows that the appreciation of the RMB against the US$ since 2005 has been compounded by a further appreciation of the RMB against the Japanese Yen which is the main trading partner and rival in the international market. The weakness of the Yen against the US dollar implies the RMB is appreciating fast against the regional economic power. This indicates a careful examination of the trends in currencies in the basket that might have further direct and indirect impact on the appreciation of the RMB and its impact on the domestic economy. Now that the RMB exchange rate is determined by taking into consideration a basket of reference currencies, the management of the exchange rate should take a careful assessment of the economic, trade, exchange rate policy, and related issues in all economies whose currencies are included in the basket of RMB exchange rate reference. The recent depreciation of the yen against the US dollar and the Euro, for instance, suggests that RMB appreciation against the US dollar should be checked, or even allowed to depreciate, to reflect the situation in the independently floating exchange rate market. By doing so, the PBOC signals to market participants that the appreciation of the RMB against the dollar is not a one-way path but a process that reflects the relative performance of the major trading and financial partners of the Chinese economy.

The excessive appreciation of the RMB against the US dollar and the Japanese yen could trigger slowdown not only in export sector but also import sector and the rest of the national economy. Slowdown in the growth rate of the national economy, especially when initiated by exchange rate mismanagement, could have costly effects on the national economy. It is therefore important that the rate of appreciation of the RMB be maintained within the capacity of the tradable sector to absorb the shock. This needs to continue as long as the net export sector and investment remain the dominant driving force of the growth of the national economy. When the economy grows further, rebalancing the structure of growth with domestic demand and expansion of spending could reduce the relative importance of the export sector in the growth process which suggests that exchange rate policy could be guided more or less by the forces of demand and supply in the market.

V Concluding Remarks

Ensuring a sustainable economic growth and improvement in the standard of living is of paramount importance to China and its population. To achieve this objective, it is important to pursue policies that support the dynamic sector of the economy that provides significant contribution to growth rate of GDP while at the same time maintaining a healthy domestic and external balance. Achieving these objectives over a long period of time is a challenge especially when protectionist sentiments and external pressure is increasingly felt.

The exchange rate policy regime of China has come under considerable pressure in recent years and the country is eventually yielding to such pressures and undertaking reforms that might generate risks to the performance of the national economy. If China is to allow a premature appreciation of the RMB before the relative importance of investment and net exports in the growth process become less critical, the consequence could affect the performance of the rest of the economy. Appreciation of the RMB against the US$, may not significantly reduce the trade surplus and yet brings costly risk to domestic economic growth. Excessive appreciation of the RMB adversely affects export sector competitiveness and reduces its contribution to domestic growth of income that in turn reduces imports of investment items and further reduces domestic demand. This would cause slowdown in economic growth performance and may set a deflationary process. The process has costly consequences as the Japanese experience of the lost decade of the 1990s amply demonstrated. It is therefore very important for monetary policy makers in China to set their exchange rate policy based on considerations on economic and financial situations and the overall international economic environment rather than undertaking a highly risky path of reaction of protectionist sentiments from abroad. This may also have significant effects on the rest of the world. The increasing integration of the Chinese economy in the global market system and its active international trade and investment initiatives in several countries suggested that the risk of deflation and economic stagnation in China would have repercussions in a number of countries with potential threat to the stability of the global economic system.

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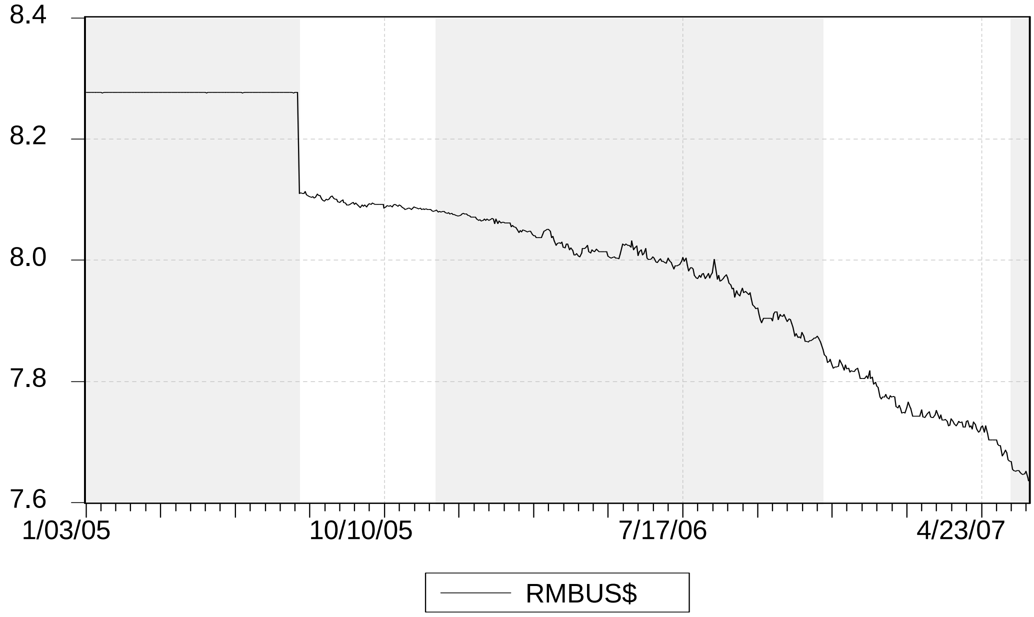
Figure 1: The daily exchange rate of the RMB per US$
(1/03/2005-6/06/2007)



Note: On July 21, 2005 the PBOC revalued the RMB from 8.27 to 8.11 to the US$. The managed floating system was introduced in which spot rate was allowed to move within a band of ±0.3 percent of the central parity rate. On November 25 2005, a swap market in forward exchange was introduced with effective forward discount rate of about 2.9 percent per year. On May 18, 2007 the band was expanded to ±0.5 percent of the central parity.

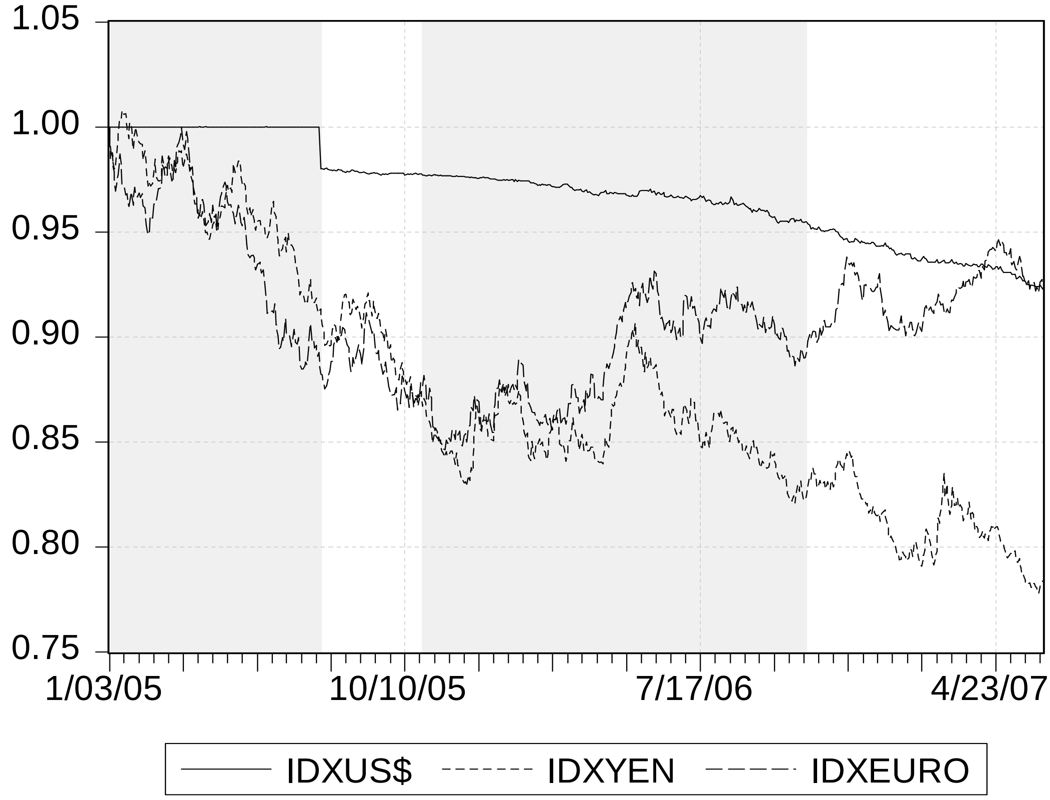


Figure 2: Index of RMB Daily Exchange Rate against US$, Japanese Yen, and Euro (2005/3/1 =1.00)